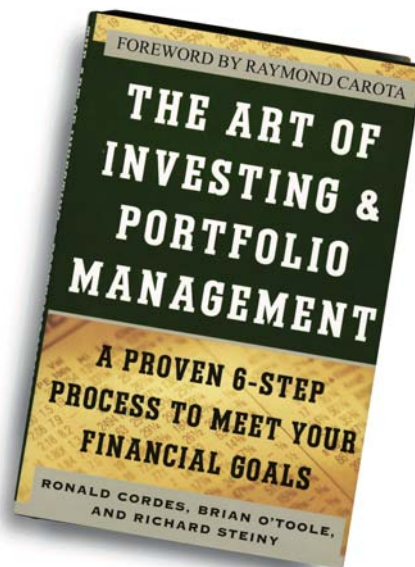


# How to Cut Through the Noise and Make Smart Decisions About Your Investments

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## PRESENTATION GUIDE



Raymond Carota

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Brandywine Financial Group, Inc.

**Presentation Guide: How to Cut Through the Noise and Make Smart Decisions About Your Money**  
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# Making Your Financial Goals Attainable

**Over the last decade the landscape of the investment world has** been significantly altered. The abundance of new options that are now available to investors has made the decision of how and where they should invest their assets an even more daunting task than ever before. With the bursting of the U.S. stock market bubble in 2000, a new environment persists in global financial markets. With this new environment, a different approach to investing is required. All individuals have specific, long-term financial goals that they hope to achieve when investing their hard earned capital; the challenge is to ensure that they are taking the proper steps to make these goals a reality.

*The Art of Investing and Portfolio Management* can be a powerful tool for investors-enabling them to truly understand the benefits of applying a time-tested, disciplined process to their investment decisions. This is the same process that is used by some of the industry's most prominent and well-respected investment strategists, and can be adapted for portfolios of any size. We believe that by providing investors with this level of knowledge and capability will prepare them to make educated, informed decisions about their money.

Our goal at Brandywine Financial Group is to provide all of our current and potential clients with the tools that they need to ensure their financial success. We truly hope that this information provides you with the knowledge to make your financial dreams come true.

Sincerely,



Raymond Carota  
President  
Brandywine Financial Group, Inc.

## Why Aren't More Individuals Successful at Investing?

**T**OO MANY INVESTORS LET THEIR EMOTIONS DICTATE THEIR actions. They chase after hot stocks and market sectors that are due to fall, ignore investments that are undervalued and poised to rise and, as a result, often earn poor returns that fail to get them to their most important financial goals.

Why aren't more individuals successful investors? One primary reason is that they are overwhelmed by the noise in the marketplace, and fail to rely on the facts when it comes to making investing decisions.

This noise manifests itself in two ways. First, investors experience an *information overload*. From cable news shows to the Internet to newspapers, magazines and books, investors are inundated with information. (See Exhibit 1.) Unfortunately, information is not knowledge. Despite receiving a large quantity of information, these investors still obtain little quality knowledge.

Second, in their efforts to sort through the morass of information, investors run into a *confusing delivery system*. This delivery system includes everyone



from friends and family members to financial professionals such as CPAs, insurance agents and financial planners. (See Exhibit 2.)

Given the many different messages investors receive from this myriad of delivery systems, it's of little surprise that more people are not successful at investing. In this environment, who should you trust to help you make smart investment decisions?

To fully answer that question, it's useful to first understand the most common mistakes that investors make. We'll focus on this topic in the next section.



## The Three Most Common Investor Mistakes

**B**EFORE WE TURN TO THE STEPS THAT LEAD TO INVESTMENT success, we'll examine the mistakes that investors most commonly make. Each of these mistakes offers insight into how investors usually approach investing, as well as a glimpse at how they could approach it differently—and more successfully.

### **Common Mistake #1: Letting Emotions Influence Investment Decisions**

We like to think of ourselves as rational creatures in all that we do. All of us would like to believe that when we make decisions, we evaluate the facts in front of us in a thoughtful manner that allows us to make intelligent, informed choices.

Unfortunately, our experience as investment advisors, as well as a growing body of academic research, tells us something very different. We have learned that investors, left to their own devices, systematically let their emotions override rational thought when it comes to deciding whether to buy or sell an investment.

Instead of basing their decisions on empirical data such as a company's earnings growth rate and future prospects, a stock's valuation relative to the market or to comparable investments, their own tolerance for risk, and so on, investors get caught up in a wave of emotions that causes them to misinterpret the facts and make irrational investment decisions. The result: Investors make the wrong moves at the wrong times, which increases their risk of failing to achieve their most important financial objectives.

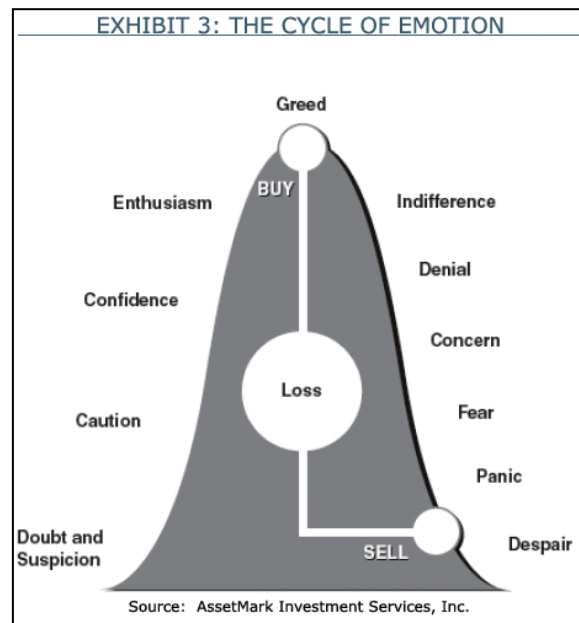
Researchers have found that investors often go through a "cycle of emotion" that affects every aspect of an investment decision. (See Exhibit 3.) Using a hypothetical example of what happens to the typical investor who gets a hot stock tip, here's how this cycle of emotion causes us to make poor choices.

Suppose you are at a neighborhood cocktail party, and you overhear someone whom you respect touting a “hot stock pick”. If you’re like most investors, you’re a bit suspicious and don’t race out right away and buy the stock right away. Instead, you decide to follow it for a while to see how it does. Sure enough, it starts trending upward.

You follow it for a while as it rises. What’s your emotion? Confidence. You hope that this will be the one investment that helps you make a lot of money. As the investment continues its upward trend, a new emotion emerges. What is the new emotion? It’s greed. You decide to buy the stock that day.

Of course, you know what happens next. Soon after you buy it, the stock starts to go down. You begin to feel new emotions. At first you’re indifferent to the decline because you’re probably still looking at a gain (on paper, anyway). As the stock continues to slide below your purchase price, you refuse to admit the possibility that the peak has been reached. Denial clouds your decision-making ability.

Instead, the stock price keeps sliding, and you start to feel concern and fear. It seems you’ve made a big mistake, and you promise yourself that if it just goes back to where you bought it, you’ll never do it again. Making money is no longer the issue. You just want to break even so that you don’t have to tell your spouse, friends, or accountant about your bad investment decision.



Now let’s say the stock continues to spiral downward. You find yourself with a new emotion—panic. As the shares free fall and your financial picture looks grimmer, you lose the ability to assess the situation rationally. Wanting nothing more than relief from the stress of your present

situation, you sell—realizing a significant loss.

Then what happens? All too often new information comes out about the company, and the stock launches a big recovery. You bought in at or near the top, only to hold on during the downturn just long enough to get scared and sell at the bottom.

Most of us are poorly wired for making prudent investment decisions. Emotions are powerful forces that cause you to do exactly the opposite of what should be done. That is, your emotions lead you to buy high and sell low. If you do that over a long period of time, you'll cause serious damage to your investments and ultimately, to your ability to reach your financial goals.

## Common Mistake #2: Chasing Last Year's Winners and Other "Hot" Investments

The second common investor mistake is to chase last year's winners and other "hot" investments. Investors mistakenly assume that the investments that did well last year will extend their good performance. In

fact, this is almost never the case.

Exhibit 4 shows the annual investment returns for the major asset classes from 1982 through 2004. As you can see, it's unusual for any one asset class to sustain the highest returns for more than several years. When one does, it often then falls sharply from being the top-performer to one of the worst performers.

EXHIBIT 4:  
THE CALLAN PERIODIC TABLE OF INVESTMENT RETURNS  
FOR SELECT ASSET CLASSES (1985-2004)  
RANKED IN ORDER OF PERFORMANCE (BEST TO WORST)

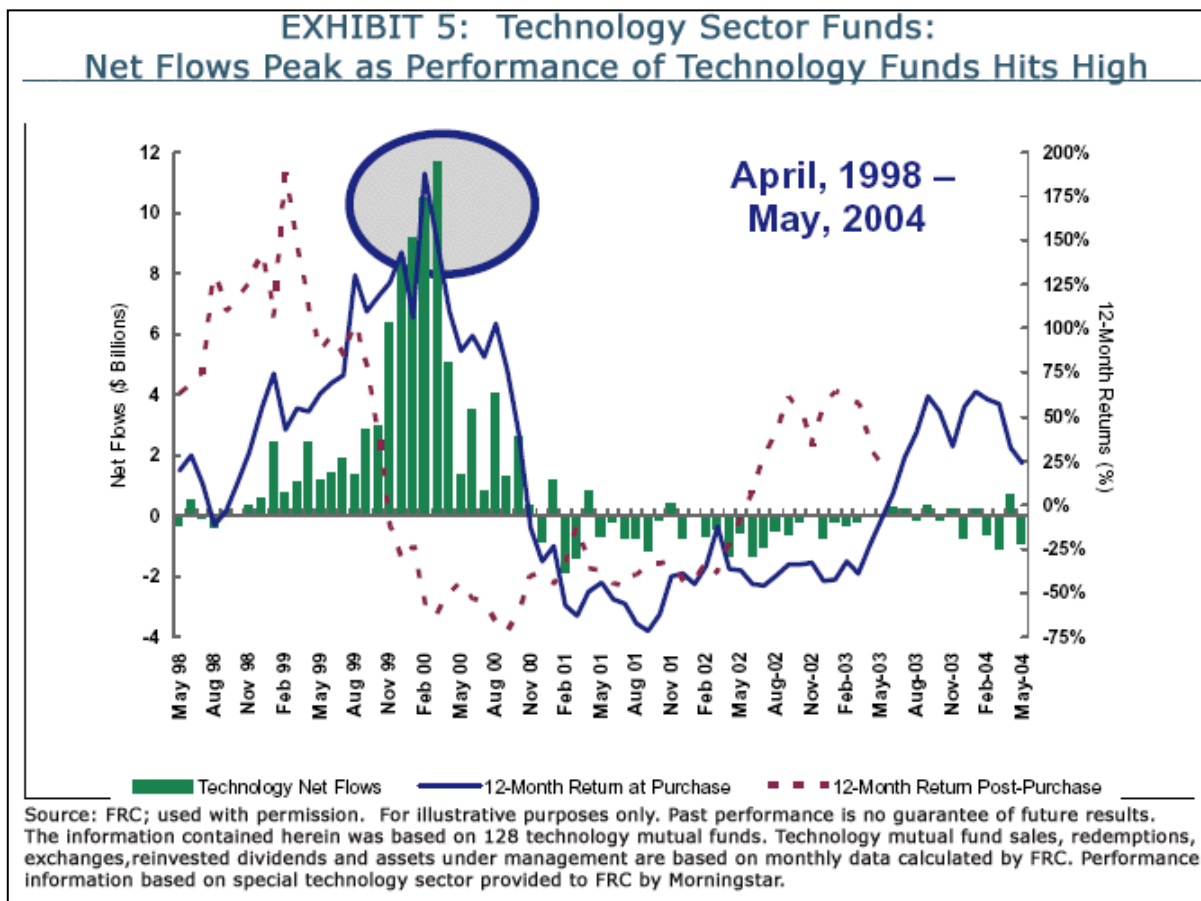
1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
MSCI EAFE	MSCI EAFE	MSCI EAFE	Russell 2000 Value	S&P/Barra 500 Growth	LB Agg	Russell 2000 Growth	Russell 2000 Value	MSCI EAFE	MSCI EAFE	S&P/Barra 500 Growth	S&P/Barra 500 Growth	S&P/Barra 500 Growth	S&P/Barra 500 Growth	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Value	LB Agg	Russell 2000 Growth	Russell 2000 Value
56.14%	69.46%	24.64%	28.47%	36.40%	8.96%	51.19%	28.14%	32.57%	7.78%	38.13%	23.97%	36.52%	42.16%	43.09%	22.83%	14.02%	19.26%	48.54%	22.25%
S&P/Barra 500 Growth	S&P/Barra 500 Value	S&P/Barra 500 Growth	MSCI EAFE	S&P 500 Value	S&P/Barra 500 Growth	Russell 2000	Russell 2000	Russell 2000 Value	S&P/Barra 500 Growth	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P/Barra 500 Growth	LB Agg	LB Agg	Russell 2000 Value	Russell 2000 Value	MSCI EAFE
33.31%	21.67%	6.59%	28.26%	31.89%	0.30%	46.04%	18.41%	23.77%	37.59%	22.94%	33.36%	28.59%	28.24%	11.63%	9.43%	-11.49%	47.25%	20.25%	
S&P 500 Index	S&P 500 Index	S&P 500 Index	Russell 2000	S&P/Barra 500 Value	S&P 500 Index	Russell 2000	S&P/Barra 500 Value	Russell 2000	S&P/Barra 500 Value	S&P/Barra 500 Value	S&P/Barra 500 Value	Russell 2000	MSCI EAFE	MSCI EAFE	S&P/Barra 500 Value	Russell 2000	MSCI EAFE	Russell 2000	Russell 2000
31.73%	18.67%	5.25%	25.02%	26.13%	-3.11%	41.79%	10.52%	18.88%	1.32%	36.99%	22.90%	31.78%	20.09%	28.96%	6.08%	2.49%	-15.94%	46.93%	18.33%
Russell 2000	LB Agg	S&P/Barra 500 Value	S&P/Barra 500 Value	Russell 2000	S&P/Barra 500 Value	S&P/Barra 500 Growth	Russell 2000	S&P/Barra 500 Value	S&P/Barra 500 Value	Russell 2000	Russell 2000	S&P/Barra 500 Value	S&P/Barra 500 Value	Russell 2000	Russell 2000	Russell 2000	Russell 2000	MSCI EAFE	S&P/Barra 500 Value
31.05%	15.30%	3.68%	21.67%	20.17%	-6.85%	38.37%	7.77%	18.61%	-0.64%	31.04%	21.37%	29.38%	14.89%	21.26%	-3.02%	-8.23%	-20.48%	38.59%	15.71%
Russell 2000 Value	S&P/Barra 500 Growth	LB Agg	Russell 2000 Growth	Russell 2000	Russell 2000	S&P 500 Index	S&P 500 Index	Russell 2000 Growth	Russell 2000	Russell 2000	Russell 2000	Russell 2000	LB Agg	S&P 500 Index	S&P/Barra 500 Value	S&P/Barra 500 Value	S&P/Barra 500 Value	S&P/Barra 500 Value	Russell 2000 Growth
31.01%	14.50%	2.75%	20.37%	16.28%	-17.41%	30.47%	7.62%	13.37%	-1.54%	28.45%	16.48%	22.36%	8.79%	21.04%	-9.11%	-11.71%	-20.86%	31.79%	14.31%
Russell 2000 Growth	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	LB Agg	Russell 2000	S&P/Barra 500 Value	LB Agg	S&P 500 Index	Russell 2000	Russell 2000	Russell 2000	Russell 2000	Russell 2000	MSCI EAFE	MSCI EAFE	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index
30.97%	7.41%	-7.11%	16.81%	14.53%	-19.48%	22.56%	7.40%	18.08%	-1.82%	25.75%	11.28%	12.95%	1.23%	-14.17%	-11.89%	-22.10%	28.66%	10.88%	
S&P/Barra 500 Value	Russell 2000	Russell 2000	S&P/Barra 500 Value	Russell 2000	Russell 2000	LB Agg	S&P/Barra 500 Growth	LB Agg	Russell 2000	LB Agg	MSCI EAFE	LB Agg	Russell 2000	LB Agg	S&P/Barra 500 Growth	S&P/Barra 500 Growth	S&P/Barra 500 Growth	S&P/Barra 500 Growth	S&P/Barra 500 Growth
29.68%	5.88%	-8.80%	11.95%	12.43%	-21.77%	16.00%	5.96%	9.75%	-2.43%	18.48%	6.05%	9.64%	-2.55%	-0.82%	-22.08%	-12.73%	-23.59%	25.86%	6.13%
LB Agg	Russell 2000 Growth	Russell 2000	LB Agg	MSCI EAFE	MSCI EAFE	MSCI EAFE	MSCI EAFE	S&P/Barra 500 Growth	LB Agg	MSCI EAFE	LB Agg	MSCI EAFE	Russell 2000	Russell 2000	Russell 2000	MSCI EAFE	Russell 2000	Russell 2000	LB Agg
22.13%	3.58%	-10.48%	7.88%	10.63%	-23.45%	12.14%	-12.18%	1.68%	-2.92%	11.21%	3.64%	1.78%	-4.45%	-1.48%	-22.43%	-21.44%	-30.26%	4.10%	4.34%

- S&P 500 Index measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-value-weighted index of 500 stocks that are traded on the NYSE, AMEX and NASDAQ. The weightings make each company's influence on the Index performance directly proportional to that company's market value.
- S&P/Barra 500 Growth and ■ S&P/Barra 500 Value indices measure the performance of growth and value styles of investing in large cap U.S. stocks. The indices are constructed by dividing the stocks in the S&P 500 Index according to price-to-book ratios. The Growth index contains stocks with higher price-to-book ratios. The Value index contains stocks with lower price-to-book ratios. The indices are market-capitalization-weighted and their constituents are mutually exclusive.
- Russell 2000 Index measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest stocks in the broad-market Russell 3000 Index. These securities are traded on the NYSE, AMEX and NASDAQ.
- Russell 2000 Value and ■ Russell 2000 Growth indices measure the performance of growth and value styles of investing in small cap U.S. stocks. The Value index contains those Russell 2000 securities with a less-than-average growth orientation, while the Growth index contains those securities with a greater-than-average growth orientation. Securities in the Value index generally have lower price-to-book and price-earnings ratios than those in the Growth index. The constituent securities are NOT mutually exclusive.
- MSCI EAFE is a Morgan Stanley Capital International index that is designed to measure the performance of the developed stock markets of Europe, Australasia and the Far East.
- LB Agg is the Lehman Brothers Aggregate Bond index. This index includes U.S. government, corporate and mortgage-backed securities with maturities of at least one year.

Source: Data from the Callan Periodic Table. Callan Associates, Inc., 2002. Used with permission. Data as of 12/31/02. For illustrative purposes only. Security indices are unmanaged. They assume reinvestment of distributions and interest payments and do not take into account fees, taxes and other charges. Such fees and charges would reduce performance. It is not possible to invest directly in an index. Past performance does not guarantee future results. Investments in foreign and small company stocks may be more volatile and may have a higher degree of risk.

The performance of international stocks from 1985 through 1992 is a good example. For the four years from 1985 to 1988, this asset class is at or near the top of the returns chart. However, in 1987, it dropped all the way to the bottom, and stayed there for four years. Investor who chased the performance of the 1985-88 period would have found themselves in the following years with the worst-performing stocks on their hands.

Another example of the dangers of chasing hot investments can be seen in Exhibit 5. As returns in the technology sector hit all-time highs in the late 1990s and early 2000, investors poured their money into technology funds at a very high rate. However, those individuals who invested just before, during and just after the period of peak performance experienced negative returns in the months and years following the bursting of the technology bubble.

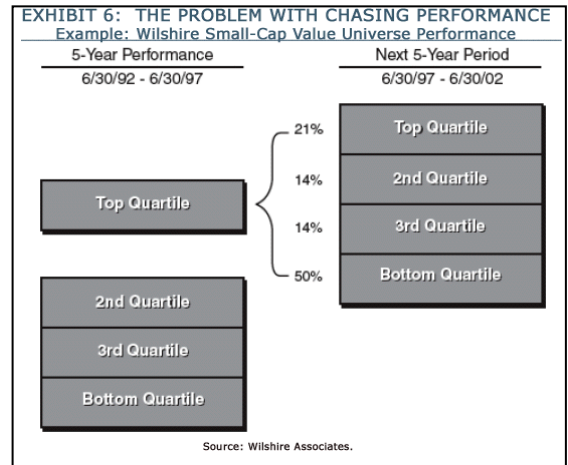


### Common Investor Mistake #3: Relying upon Faulty Rules of Thumb

The third mistake investors commonly make is putting their trust in faulty rules of thumb. Perhaps the most pervasive and harmful rule of thumb that works its way into investors' minds (despite what is written on every prospectus) is the following: *Past performance is a good predictor of future results.*

The assumption that any investment manager's performance over a limited time period is indicative of its performance going forward has been repeatedly proven to be absolutely false. Some of the most compelling evidence we've seen comes from one of our strategic institutional investment consulting partners, Wilshire Associates. By examining a large "universe" of managers that run both mutual funds and institutional accounts, they identified the small-cap value managers that performed in the top quartile (top 25 percent) of their category during the five years ending 1997 and tracked their performances for the following five years.

Wilshire's findings show that past performance is, in fact, an extremely poor predictor of future results. (See Exhibit 6.)

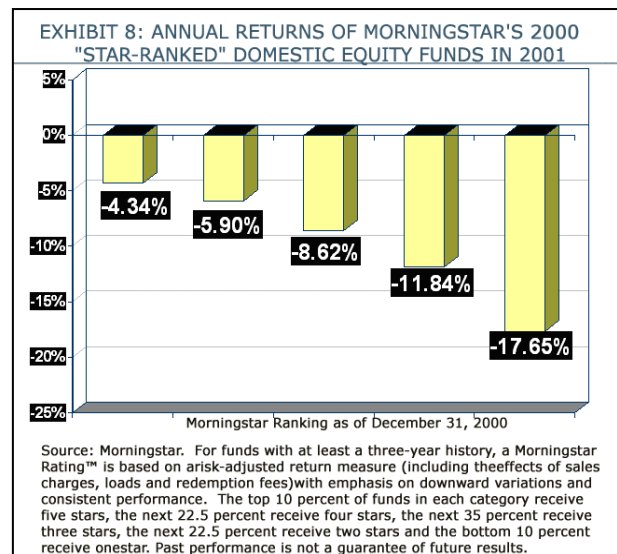
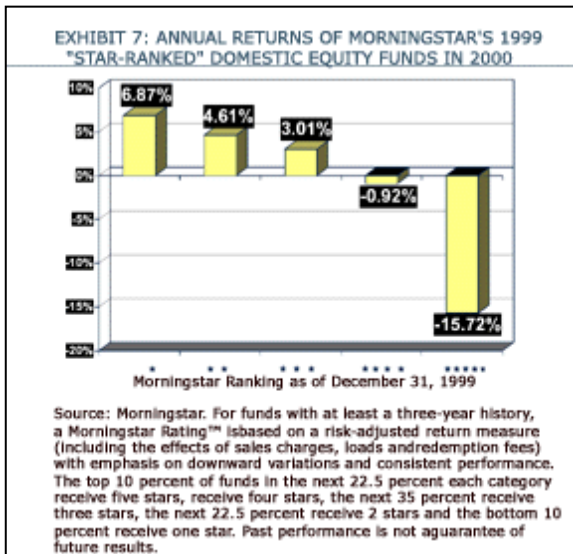


Of the managers that delivered top-quartile returns during the first five-year period, just 21 percent managed to do the same during the second five-year period. Amazingly, a full 50 percent of these managers posted bottom quartile returns—the worst possible.

Morningstar's star ranking system for mutual funds reveals another excellent example of the problem inherent in relying on the faulty rule of thumb that past performance indicates future results. Morningstar calculates each fund's risk-adjusted return and then assigns one, two, three, four or five stars to each fund according to its

performance. While investors often assume that the top-ranked funds—those receiving four or five stars—are the best buy, in fact the opposite often proves true.

By chasing the hottest funds of the previous year, investors in 2000 and 2001 would unwittingly have bought those funds that turned out to be the worst performers.



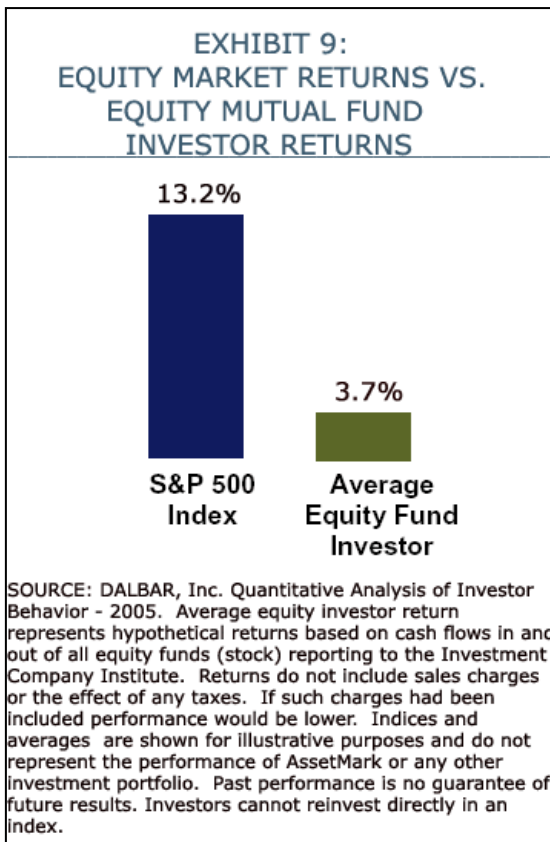
Exhibits 7 and 8 show the annual returns of domestic funds for the years 2000 and 2001, broken out by their star rating. As you can see, those funds ranked with five stars at the end of 1999 actually performed far worse throughout 2000 than all other funds. In fact, the funds given one star at the end of 1999 had the *best* performance in 2000. This pattern repeated itself in 2001.

## Investor Mistakes Lead to Poor Performance

Given the frequency with which investors make these three most common mistakes, it's not surprising that many investors are unsuccessful. Unfortunately, most investors have experienced dramatically lower returns over the past 20 years than the major market benchmark, the Standard & Poor's 500 Index. In fact, as Exhibit 9 illustrates, the S&P 500 enjoyed an average annual return of 13.2

percent from 1984 to 2004. According to industry research firm Dalbar, however, average equity mutual fund investors saw an average yearly return in their personal portfolios of just 3.7 percent. These investors have paid a heavy price for their missteps.

To experience true success as an investor, you need a framework that will not only enable you to sidestep the common pitfalls, but that also will allow you to leverage capable investment professionals who will help you follow a disciplined investment process and guide your strategy through the ever-shifting stock market conditions. We will examine exactly how to do that in the next section.



## Three Key Concepts to Investment Success

**WE BELIEVE THAT THERE ARE THREE KEY CONCEPTS THAT WILL empower you to achieve consistent, long-term investment success.**

These are the concepts that will guide you regardless of which direction the market is heading.

It's important to note here that while these concepts are designed to maximize return, no strategy can eliminate risk, which is inherent in all investments. Whenever you invest, you have to accept some risk. It's also important to remember that you're responsible for reviewing your portfolio and risk tolerance, and for keeping your financial advisor current on any changes in either your risk tolerance or your life that might affect your investment objectives.

### **Key Concept #1: Build an Investment Management Team that Delivers Great Capability**

As an investor looking to achieve lasting investing success, you need to build a team of professionals that

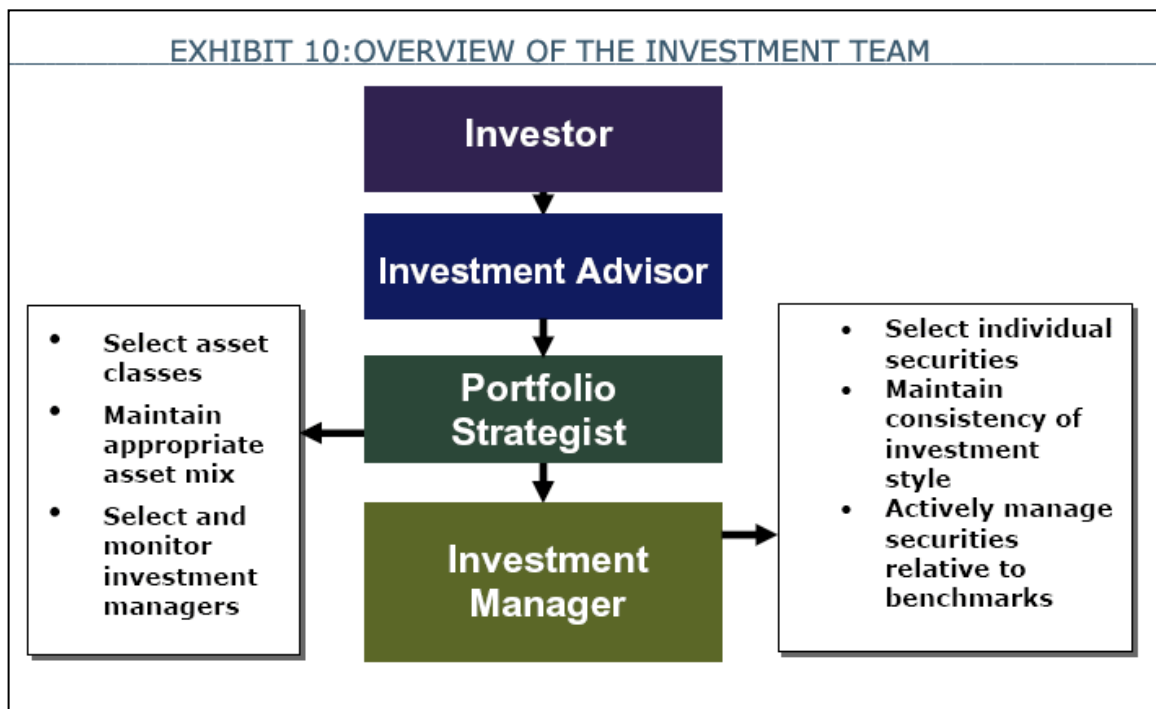
maximize your chances for reaching your most important financial goals. This team should consist of three key players:

**Investment advisor.** Your advisor's job is to provide you with the information you need to make smart investment decisions and to keep you abreast of developments and changes both in the market and in your own portfolio. Your investment advisor will be responsible for understanding your personal financial goals, translating those goals into a thoughtful and comprehensive plan of action and selecting and implementing a team of specialists that will assist in executing your investment plan. The investment advisor's next primary action will be to select the next key member of your investment management team: the portfolio strategist.

**Portfolio Strategist.** Portfolio strategists are teams of analysts, academics and other investment experts that typically are part of large institutional investment management operations. Financial services firms, such as Goldman Sachs and UBS Global Asset Management, have dedicated teams of portfolio strategists that serve their largest clients. These strategists all share one overarching purpose: to build optimal portfolios managed by the best financial minds in the business. Portfolio strategists have three main responsibilities: selecting asset classes in which to invest, determining and maintaining optimal target mixes of those asset classes and selecting and monitoring investment managers.

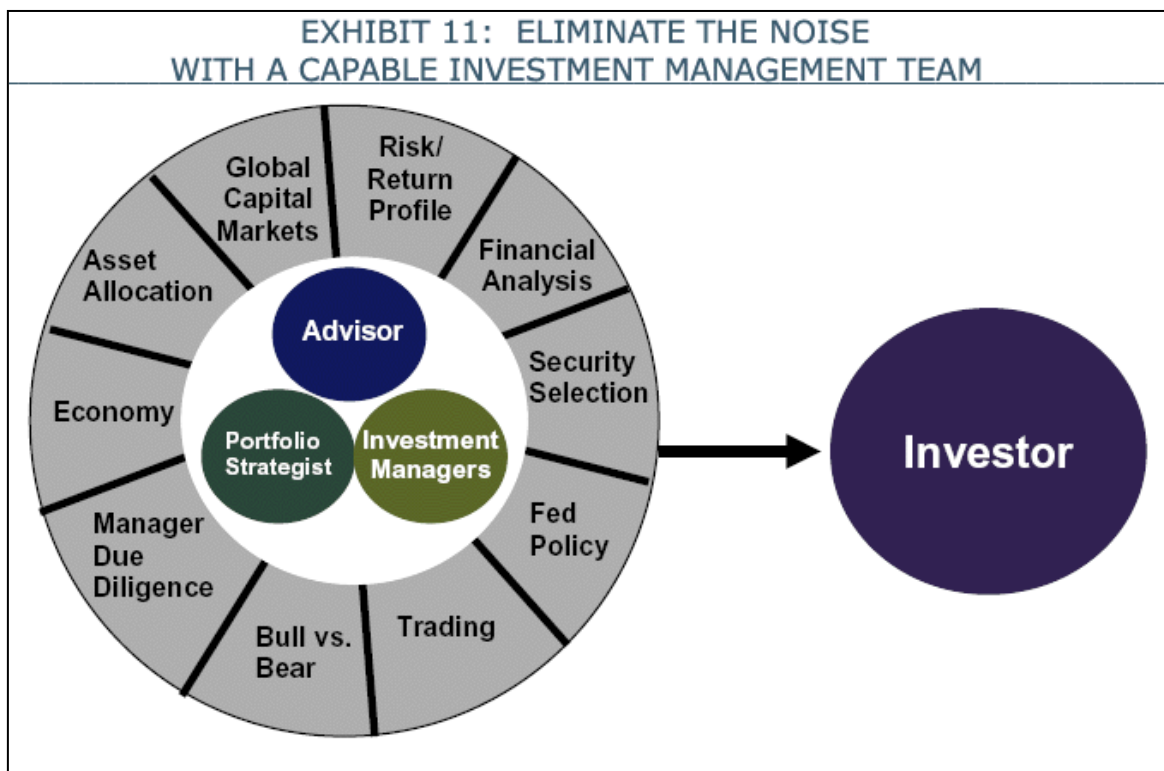
**Investment Manager.** The investment manager is chosen by the portfolio strategist to implement the asset allocation strategy that was determined by the portfolio strategist. Specifically, this means choosing the individual securities that will be used within each asset class, ensuring that these selections remain true to the required investment style over time and managing those securities relative to market benchmarks.

Exhibit 10 provides an overview of the investment team, including the key differences between the portfolio strategist and the investment manager. We believe that building this kind of team may help you maximize your chances of investment success. A good investment management team



will also help you eliminate the noise which, as we saw in the first section, makes it so difficult to make wise financial decisions. As Exhibit 11 illustrates, there is a wide range of factors to consider in any investment decision, from the health of the economy to your own

tolerance for risk. By systematically and unemotionally accounting for each of these factors, your investment team effectively dampens the noise by delivering only the quality information required to help you make decisions.

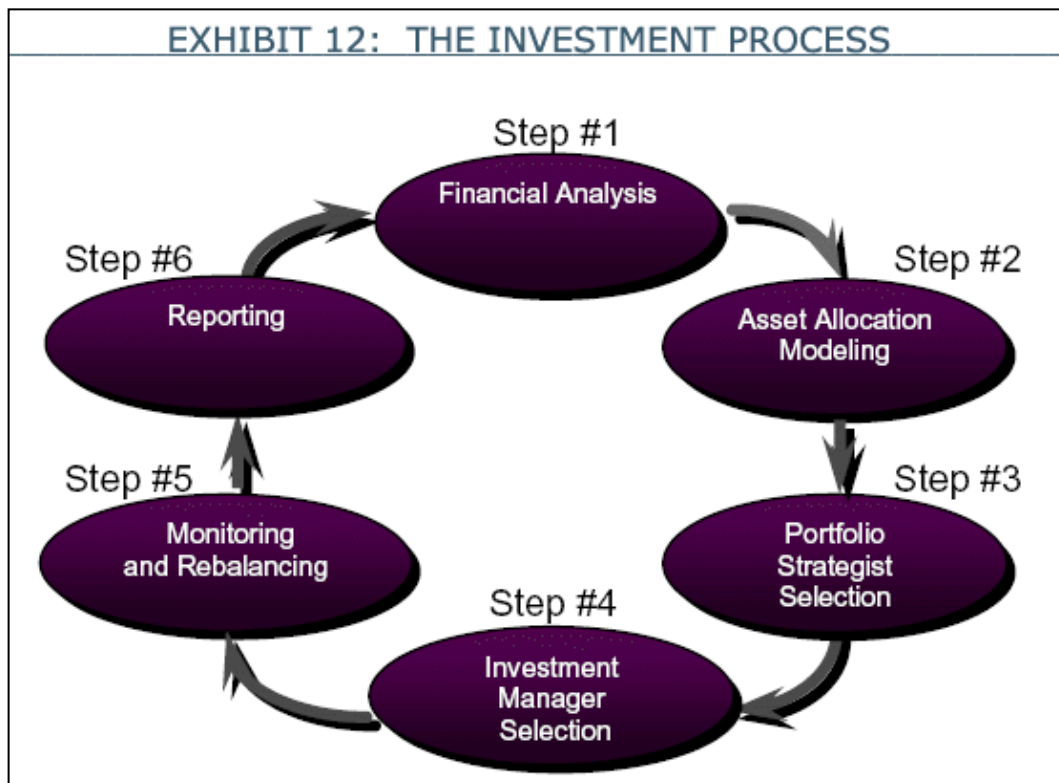


## Key Concept #2: Follow a Disciplined Investment Process

When it comes to crafting and implementing a high-quality investment program, you should leave nothing to chance. It's for this reason that we recommend the following systematic, six-step investment process. (See Exhibit 12 for an overview of the six steps.)

By working with a dedicated investment advisor responsible for coordinating an investment management team that implements a disciplined approach, you'll ensure that you cover every important area of the decision-making, strategy-implementation and portfolio-maintenance processes.

**Step #1: Financial analysis.** Your investment advisor should work with you to clearly define your financial



values and goals, your time horizon for achieving your goals, the rate of return your portfolio will need to achieve over time to reach your goals and your tolerance for risk. In addition, your advisor should have a thorough understanding of your current financial situation, including your net worth, investable assets for funding your goals, your current investment structure and your tax situation.

**Step #2: Asset allocation modeling.** In this critical step, your investment advisor will determine how your assets should be allocated among the major asset classes in order to maximize your ability to reach your goals. If your advisor is working as part of an investment management team—as we recommend—they will be responsible for selecting the portfolio strategist to accomplish this step.

**Step #3: Portfolio strategist selection.** As we've seen, the portfolio strategist is the team of experts devoted to making asset allocation decisions. The portfolio strategist selected by your investment advisor should have substantial research capability across global capital markets, have asset allocation and portfolio strategy as a core

competency and use investment policy committees composed of senior investment professionals to scrutinize and evaluate their recommendations.

**Step #4: Investment manager selection.** In this step, the portfolio strategist will select the individual managers who will oversee the investments used in your plan. The very best portfolio strategists evaluate managers on a wide range of factors, such as the quality of their investment process and philosophy, the experience and talent of the investment personnel, the stability of the organization and the sophistication of portfolio construction and risk management.

**Step #5: Monitoring and rebalancing.** Your portfolio strategists will periodically rebalance your portfolio as required. Through such rebalancing, you are able to continually manage risk and return in accordance with your goals, time horizon and risk tolerance.

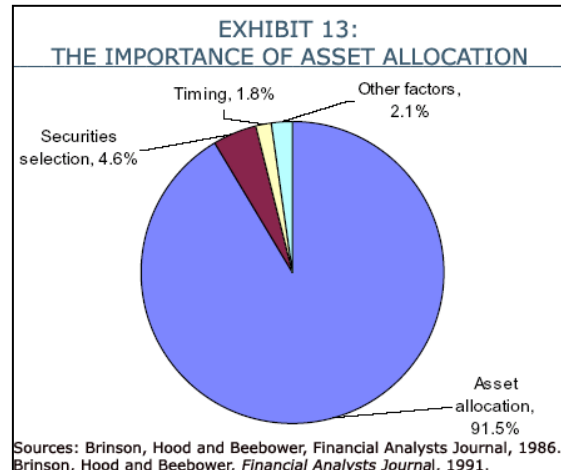
**Step #6: Reporting.** Finally, the portfolio strategist will keep your investment advisor fully informed on portfolio performance so that he or she can keep you abreast of the progress towards achieving your long-term

financial goals. You should expect monthly custodial statements, quarterly performance reports, a year-end tax planning report and online access to your account information.

Three of the steps within this process are so critical to your investment success that we will zero in on them in greater detail: asset allocation modeling, portfolio strategist selection and monitoring and rebalancing.

### **Important Fundamental: Asset Allocation**

It would be difficult to overstate the importance of asset allocation. As two well-documented landmark studies conducted by some of the world's most respected investment experts have shown, over 90 percent of the variations in returns of portfolios can be explained by a single factor: asset allocation. In contrast, the traditional area where investors focus their time and attention—selecting individual securities—explains surprisingly little of the return variations. (See Exhibit 13.)



To understand how the best asset allocation model will be formulated to meet your particular needs, it's useful to break asset allocation into its essential building blocks. The first asset allocation building block is the *historical returns of major asset classes*. These tell us much about the types of returns you might reasonably expect from a variety of asset classes.

Exhibit 14 shows the long-term historical returns of four major domestic asset classes from the end of 1925 through 2004: small-cap stocks, large-cap stocks, bonds, and Treasury bills (cash). While you may already recognize that stocks offer the greatest potential for asset growth, it may surprise you just how significantly stocks have outperformed other asset classes over the long term. A \$1 investment in the Standard and Poor's

(S&P) 500 Index of large company stocks at the end of 1925 would be worth \$2,533 in 2004. The same investment in U.S. small companies would have done even better, growing to \$12,968. By contrast, \$1 invested in U.S. bonds would have grown to \$66, and it would have grown to just \$18 if it had been invested in 30-day Treasury bills (cash). The second essential building block of asset allocation is the *historical risk of major asset classes*. By understanding the

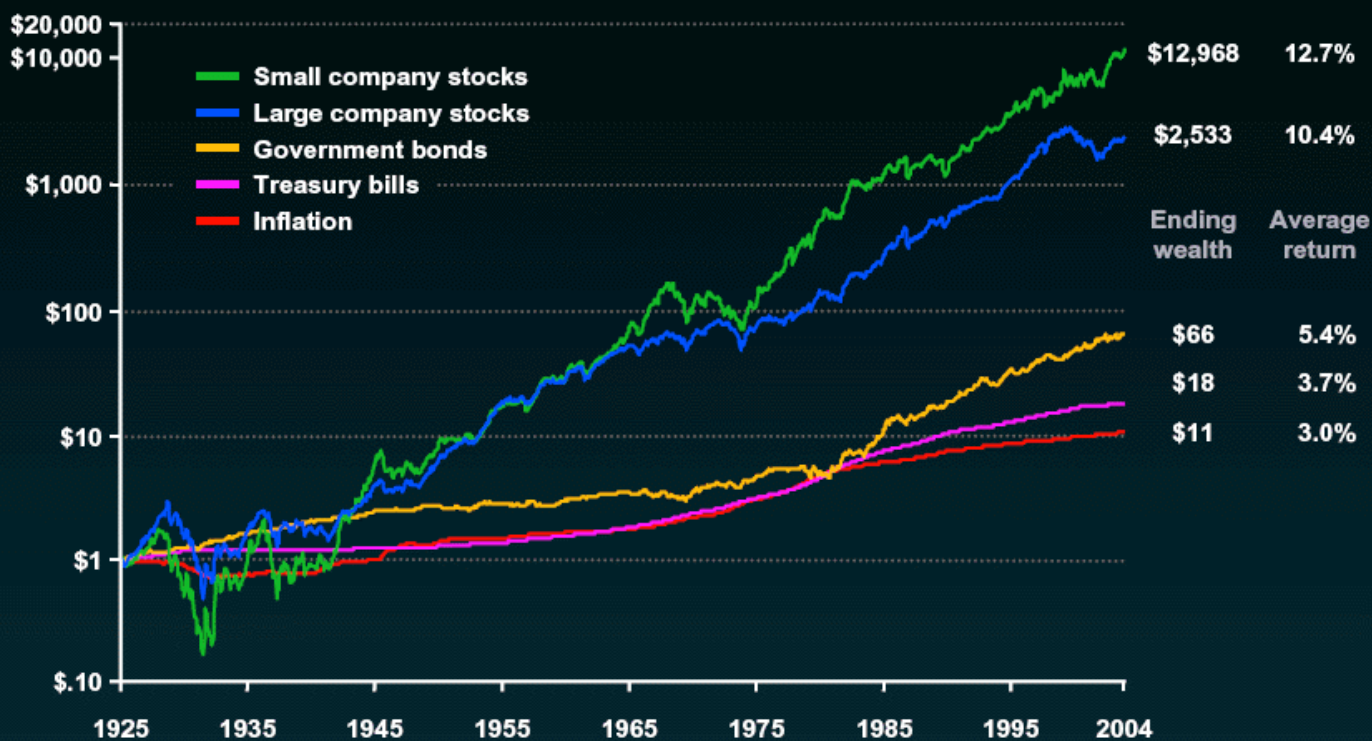
level of volatility each type of asset class historically has, you can make better judgments as to the appropriate investments for your risk tolerance level.

Higher potential returns go hand in hand with higher volatility. It's because of the risk inherent in stocks relative to fixed-income securities and cash that investors are able to earn higher rates of return in stocks over time. But stocks can swing wildly in

EXHIBIT 14: MARKET INVESTMENT RETURNS  
Growth of \$1 invested from year-end 1925 to 2004

## Stocks, Bonds, Bills, and Inflation

Year-end 1925–2004



Hypothetical value of \$1 invested at year-end 1925. Assumes reinvestment of income and no transaction costs or taxes.

Copyright © Ibbotson Associates 2005. For illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Small company stocks are more volatile than large company stocks. U.S. Treasury Bills are guaranteed as to the timely payment of principal and interest. Small Company Stocks are represented by the fifth capitalization quintile of stocks on the NYSE. Large Company Stocks are represented by the S&P 500. Government Bonds are represented by 20-year U.S. Government Bond. Treasury Bills are represented by 30-day U.S. Treasury Bill. Inflation is represented using the Consumer Price Index.

the short term and expose investors to high risk of significant losses from a time to time in pursuit of those outsized gains.

Unfortunately, simply knowing that stocks generally are more risky than bonds or cash is not enough to build a truly effective portfolio that can maximize your success. Instead, you (or your portfolio strategist) must determine quantitatively how much risk each asset class carries by using a statistical measurement called *standard deviation*.

Standard deviation indicates how far from the mean (average) an investment's historical performance has been. An asset class's total return each year reasonably can be expected to fall within one standard deviation of its expected rate of return approximately two-thirds of the time. For example, an asset class with a one-year standard deviation of 6 percent and an expected return of 8 percent should post returns that fall between 14 percent (8 + 6) and 2 percent (8 - 6) about 67 percent of the time.

Exhibit 15 shows the standard deviations of five major asset classes. The higher standard deviation of stocks—both large and small cap—

relative to bonds and cash means that their returns are more likely to swing dramatically during the short term. This is especially the case with volatile small-company stocks. Their annual return can range all the way from 50.6 to -15.6 percent about two-thirds of the time.

### EXHIBIT 15: HISTORICAL RISK OF MAJOR ASSET CLASSES, 1926-2004

#### Stocks, Bonds, Bills, and Inflation

Summary Statistics 1926-2004

	Compound annual return	Arithmetic annual return	Risk (standard deviation)
Large company stocks	10.4%	12.4%	20.3%
Small company stocks*	12.7%	17.5%	33.1%
Government bonds	5.4%	5.8%	9.3%
Treasury bills	3.7%	3.8%	3.1%
Inflation	3.0%	3.1%	4.3%

\* The 1933 small company stock total return was 142.9%

Copyright © Ibbotson Associates. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Small cap stocks are represented by fifth capitalization quintile of stocks on the NYSE. Government Bonds are represented by 20-year U.S. Government Bond. Treasury Bills are represented by 30-day U.S. Treasury Bill. Inflation is represented by the Consumer Price Index.

The third essential building block of asset allocation is *correlation coefficients*.

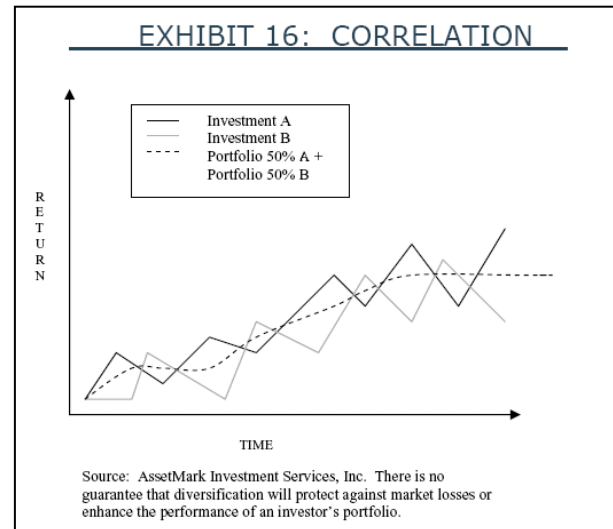
Most people understand the basic concept of diversification ("Don't put all your eggs in one basket"), but that's a very simplistic view of diversification. Instead, you must figure out how to combine various asset classes in ways that will add the most value to your investment strategy and give you the best possible return for the level of risk

with which you are comfortable. The key is to build a portfolio of asset classes that do not move in lockstep with each other. In this way, a negative return from one asset class in your portfolio can be offset by a positive return from another.

Correlation is what is used to determine the extent to which different asset classes move with each other. *Correlation* is a mathematical representation of the relationship between asset classes during an investment cycle. If two asset classes have a correlation of +1, they are said to have *perfect positive correlation*, and their values will move simultaneously in the same direction. If the assets have a correlation of -1, they have *perfect negative correlation*. Their prices therefore will move in exactly opposite directions.

By combining asset classes with low correlations, you can put together a portfolio of very volatile assets (those with high standard deviations) while actually reducing your portfolio's overall risk and achieving a smoother ride. (See Exhibit 16.)

To see low correlation at work, consider the performance of stocks and bonds over time shown in Exhibit 17. Bonds tend to perform well during periods when stocks are suffering,



and vice versa. By combining stocks and bonds into your portfolio, you can achieve strong returns while lowering the portfolio's overall level of risk. This gives you the benefits of diversification.

In contrast, you gain little or no diversification benefits if you combine two highly correlated assets with

**EXHIBIT 17: BENEFITS OF DIVERSIFICATION:  
STOCKS ZIG, BONDS ZAG**

BONDS HAVE DONE RELATIVELY WELL WHEN STOCKS HAVE NOT

U.S. STOCKS %		U.S. BONDS %
-29.3	Dec '68- June '70	2.6
-42.6	Jan '73- Sep '74	4.9
-14.1	Jan '77- Feb '78	3.2
-16.9	Dec '80- Jul '82	21.6
-29.5	Sep '87- Nov '87	2.2
-14.7	Jun '90- Oct '90	3.8
-13.4	May '98- Aug '98	3.7
-31.8	Mar '00- Jun '03	37.2

Source: UBS Global Asset Management. There is no guarantee that diversification will protect against market losses or enhance the performance of an investor's portfolio. U.S. Stocks are represented by the S&P 500. U.S. Bonds are represented by 20-year U.S. Government Bonds.

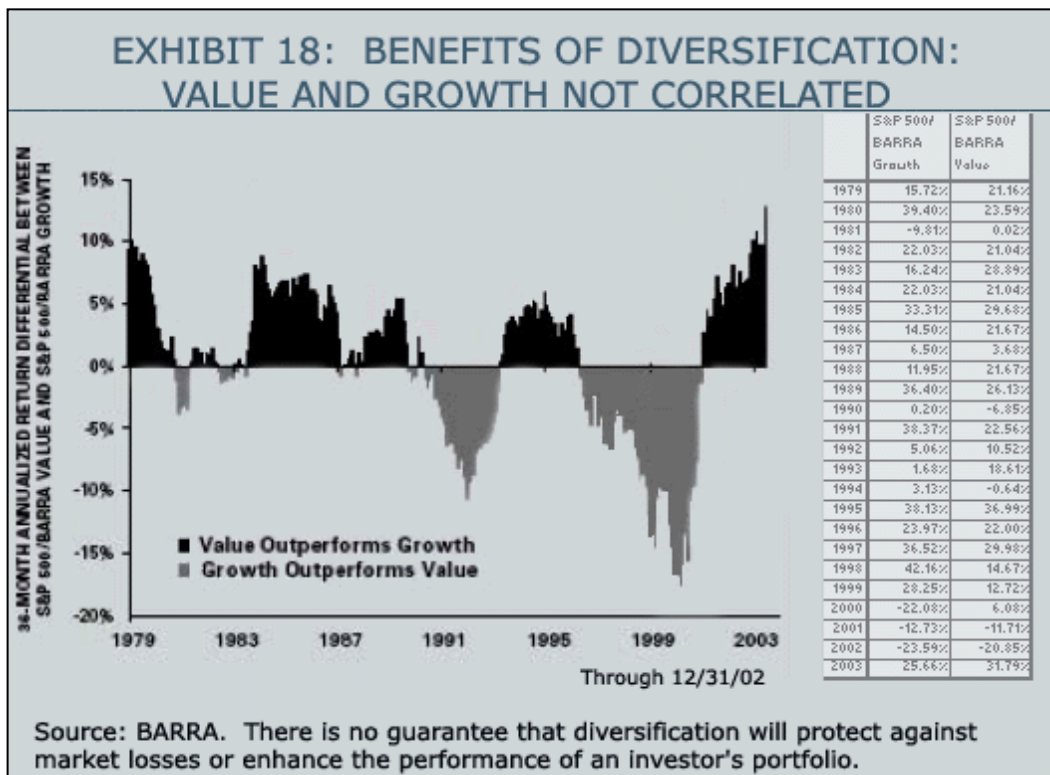
correlation relationships that are equal or close to +1. For example, dividing your money between the S&P 500 and the Dow Jones Industrial Average would not create a well-diversified portfolio. The reason: Both indices are made up of large-cap stocks of U.S. firms, so their prices almost always will move in the same direction—a bad day for the Dow will not likely be offset by a good day for the S&P 500.

The idea here is that advanced asset allocation is not simply concerned with dividing up your assets—it focuses on dividing them up scientifically in intelligent and effective ways. By ignoring correlation, you could easily fall into the trap of dividing your money among two indices—in this

case the S&P 500 and the Dow—and still end up with ineffective diversification.

For example, both large- and small-cap stocks should be considered for your portfolio because their returns are not highly correlated. As a result, your portfolio can achieve greater diversification benefits by including both. Likewise, growth stocks and value stocks often move in somewhat different cycles. Sometimes growth stocks post positive returns when value stocks are negative. Sometimes both groups deliver negative returns, but to different degrees. (See Exhibit 18.)

There are two primary ways to build portfolios using advanced asset



allocation methodologies. One is *strategic* asset allocation; the other is *tactical* asset allocation.

The strategic asset allocation approach incorporates the three building blocks we just explored. It examines historical patterns of behavior (returns, risk and correlation) among asset classes over very long periods to understand asset-class behavior. These data are used to generate long-term, forward-looking assumptions about the likely behavior of each asset class in a variety of possible economic environments. These assumptions are then used to generate a long-term target mix of assets for a portfolio.

The key characteristic you should remember about strategic asset allocation is that the target mix stays relatively constant over the investment time horizon. This is because each new year of data about an asset class doesn't significantly alter its long-term pattern.

Tactical asset allocation generally begins with the same steps as strategic asset allocation: Determining a long-term target mix by selecting asset classes and processing their return, risk, and correlation characteristics, as well as future

assumptions and asset-class selections.

Where tactical asset allocation differs is in how that target-asset mix is managed. Unlike strategic allocation, in which the portfolio's target-asset weightings stay more or less consistent during the entire investment period, tactical allocation establishes permissible ranges for each of the asset classes and seeks to shift the target mix whenever there are market opportunities that potentially can boost overall returns or reduce overall risk.

### **Important Fundamental: Hire a Capable Portfolio Strategist**

The second important fundamental in your investment process is hiring a capable portfolio strategist. There are four key areas where qualified strategists will have deep expertise and capabilities:

1. **Extensive research across global stock and bond markets.** Many portfolio strategists have offices and research professionals throughout the world, giving them unique insights into local

markets that would be difficult for most investors to possess.

2. **Proven approach to asset allocation decision making.**

As we've just seen, the asset allocation decision-making process requires great care and consideration. Portfolio strategists acutely understand that asset allocation drives performance, and therefore devote enormous resources to studying asset classes and how they interact with each other to make the most accurate constraint and capital markets assumptions.

3. **Senior investment professionals make asset allocation decisions.**

Advanced technology alone is not sufficient to perform superior asset allocation, of course. Portfolio strategists understand this fact and use investment policy committees to scrutinize and evaluate their recommendations. These committees are made up of an investment firm's most senior professionals, who typically have several decades of experience managing assets.

4. **Disciplined investment process.** Finally, portfolio

strategists use disciplined investment processes to ensure that they consistently work to the highest standards.

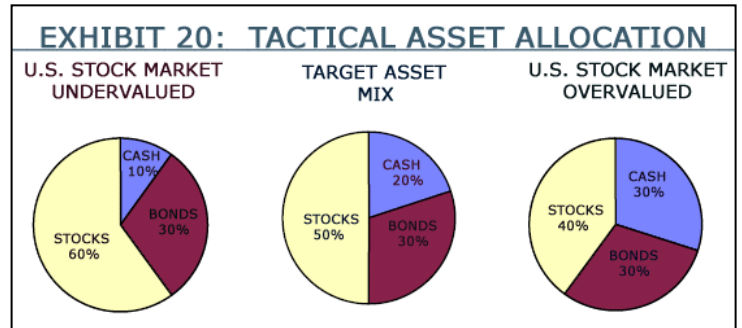
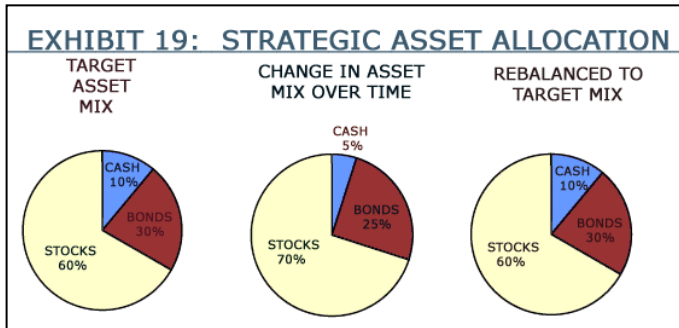
**Important Fundamental:  
Monitor and Adjust Portfolio on an Ongoing Basis**

The third important fundamental is to monitor and adjust your portfolio over time. As we've seen, the different asset classes do not move together. This means that the percentage of your assets that you have invested in each asset class will fluctuate as market conditions change. Your target asset allocation therefore will drift: As stock prices rise, for example, your exposure to stocks will increase, and vice versa. Depending on market fluctuations, your allocation to stocks over time eventually will become higher or lower than you want it to be. As a result, you may find that you've incurred a higher level of investment risk than you feel comfortable with.

To stay on track, you must rebalance your portfolio's holdings from time to time. Exhibit 19 illustrates strategic asset allocation: as the portfolio's asset mix changes over time, it is

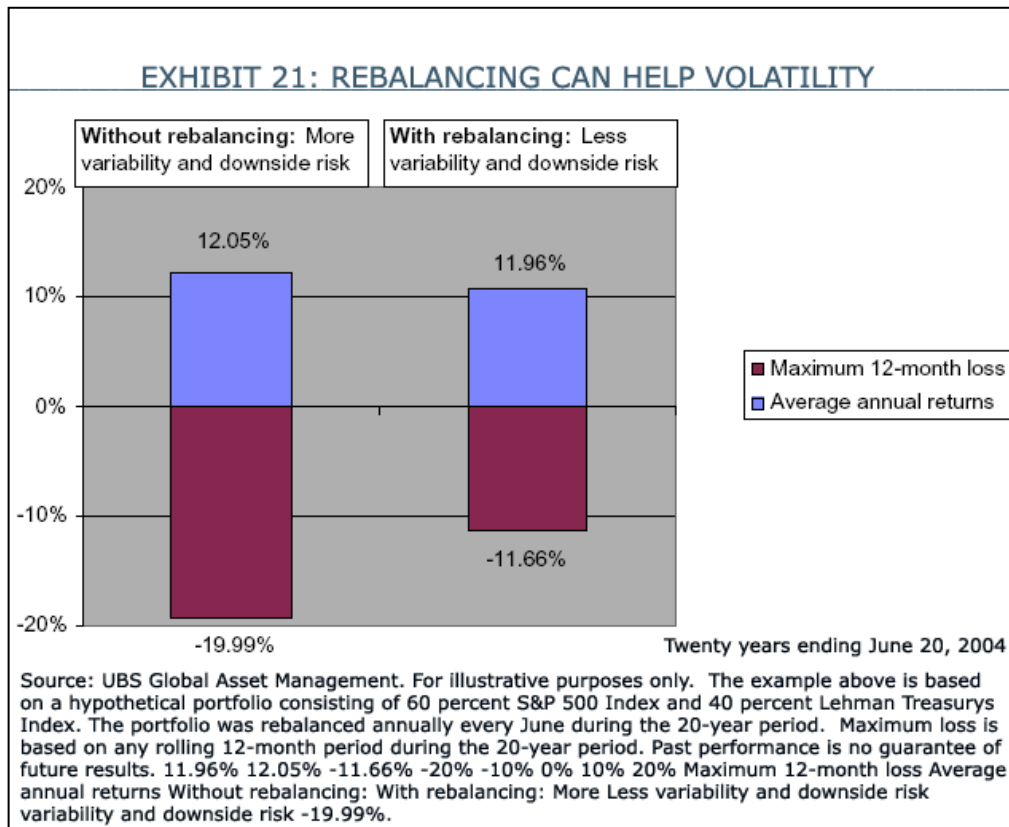
simply brought back to the original target mix.

market sectors as they arise. (See Exhibit 20.)



In contrast, tactical rebalancing does not seek to rebalance back to a target mix at regular intervals. Instead, the rebalancing decisions are based on perceived opportunities and risks among various asset classes and

In addition to continually managing risk and return in accordance with your investment plan, periodic portfolio rebalancing can also help to lower volatility. Over the past 20 years, as Exhibit 21 shows, portfolios



that were rebalanced even once per year were significantly less volatile than portfolios that were not rebalanced. And as you can see, rebalancing doesn't necessarily mean sacrificing returns.

Not only will lower volatility help you to sleep better at night, it also carries another important benefit: It actually will help to enhance your overall investment returns over time. (See Exhibit 22, which shows the growth of \$100,000 in two portfolios with different levels of volatility.) As a result, you'll build more wealth by managing volatility through rebalancing than you will by taking a simplistic, static, buy-and-hold approach.

### EXHIBIT 22: LESS VOLATILITY = GREATER

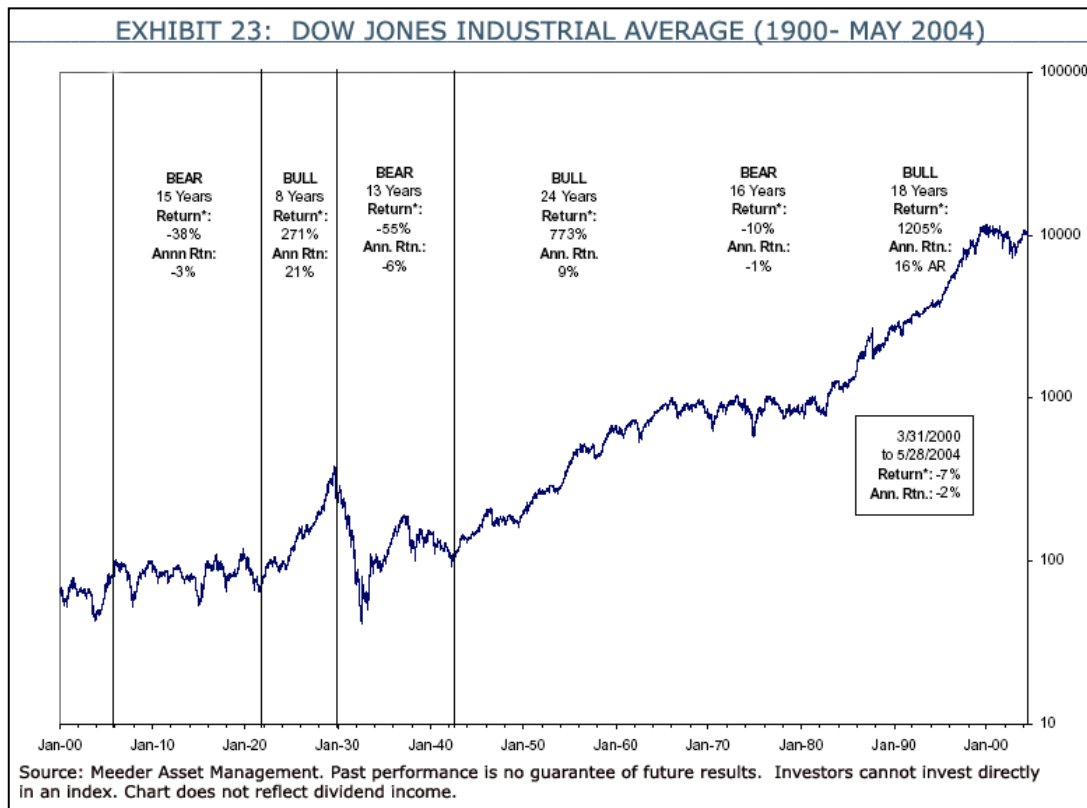
<u>CONSISTENT INVESTMENT</u>		<u>VOLATILE INVESTMENT</u>		
Year	Rate of Return	Ending Value	Rate of Return	Ending Value
1	8.00%	\$108,000	30.00%	\$130,000
2	8.00%	\$116,640	20.00%	\$104,000
3	8.00%	\$125,971	25.00%	\$130,000
4	8.00%	\$136,049	-20.00%	\$104,000
5	8.00%	\$146,933	25.00%	\$130,000
Arithmetic Return		40.00%	40.00%	
Compound Annual Return		8.00%	5.40%	

Source: CEG Worldwide. This information is hypothetical only and does not reflect the past or future performance of any specific investment.

## Key Concept #3: Adapt to Changing Stock Market Environment

Different markets demand different approaches. Even a proven, world-class plan can benefit from adjustments that reflect the market environment at any particular moment. In fact, you'll magnify your success if you adapt your approach to take advantage of the various forces at work during bull and bear markets.

As we examine the stock market over time, we see that it has experienced long periods—known as *secular markets*—during which prices move in a general direction. Exhibit 23 shows that the Dow Jones Industrial Average has gone through three secular bull markets and three secular bear markets since 1906, each of varying lengths and magnitude.



As you can see from Exhibit 24, secular bull and bear markets have lasted anywhere from seven to 24 years since 1906. Notice that the 24-year bull market from 1942 through 1965 that saw the Dow gain 9.4 percent annually was followed by a severe 16-year secular bear market

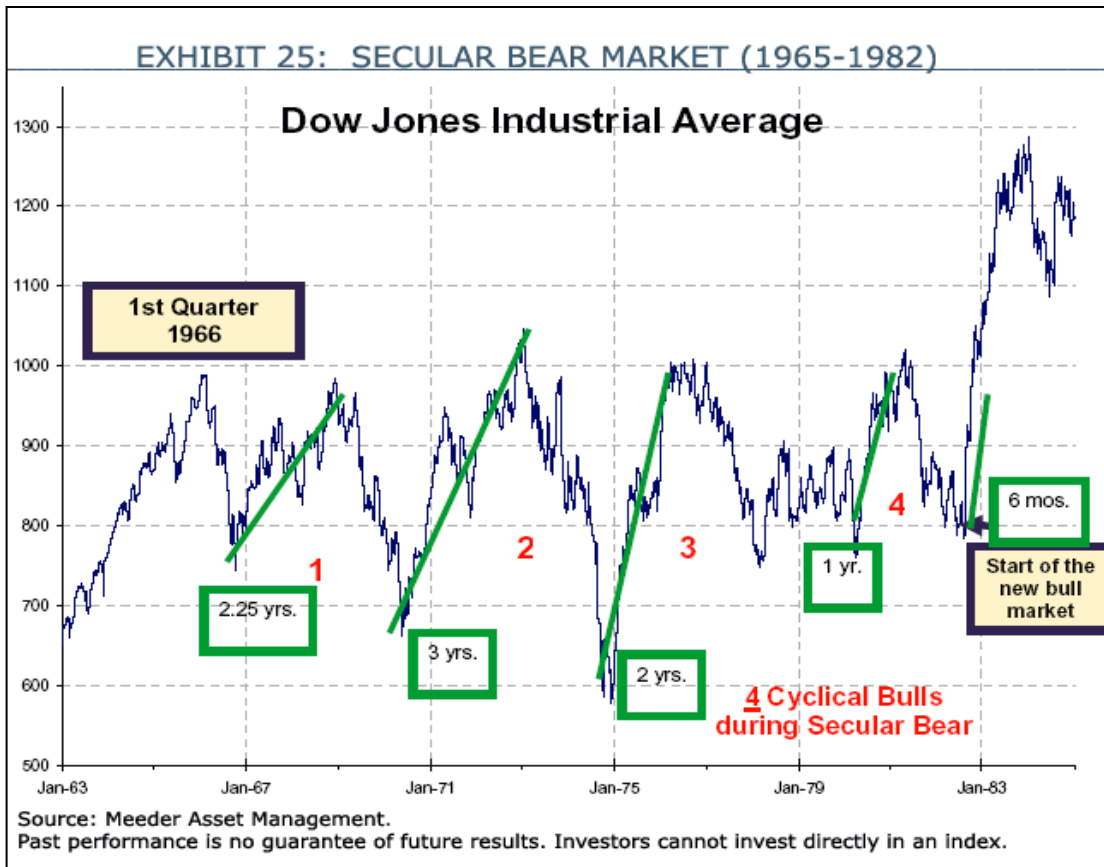
crop up repeatedly during long-term secular environments. These cyclical movements can mean big opportunities for investors during periods when the larger trend is negative.

EXHIBIT 24: ALTERNATING SECULAR BEAR AND BULL MARKETS (1906- 2004)							
	1906- 1921	1922- 1928	1929- 1941	1942- 1965	1966- 1981	1982- 1999	2000 - May 2004
<b>Type of Market</b>	Secular Bear	Secular Bull	Secular Bear	Secular Bull	Secular Bear	Secular Bull	Secular Bear
<b>Length in Years</b>	16	7	13	24	16	18	4+
<b>Annualized Return</b>	(1.1)	20.1	(7.4)	9.4	(0.6)	15.4	(2.7)
<b>Inflation Index (CPI)</b>	n/a	n/a	(0.8)	3.1	7.0	3.3	2.6
<b>Real Return</b>	(1.1)	20.1	(6.6)	6.3	(7.6)	12.1	(5.3)
Source: Morningstar, Bloomberg LP. Chart does not reflect dividends. Past performance is no guarantee of future results. Investors cannot invest directly in an index.							

during which stocks realized an annual return of *negative* .6 percent.

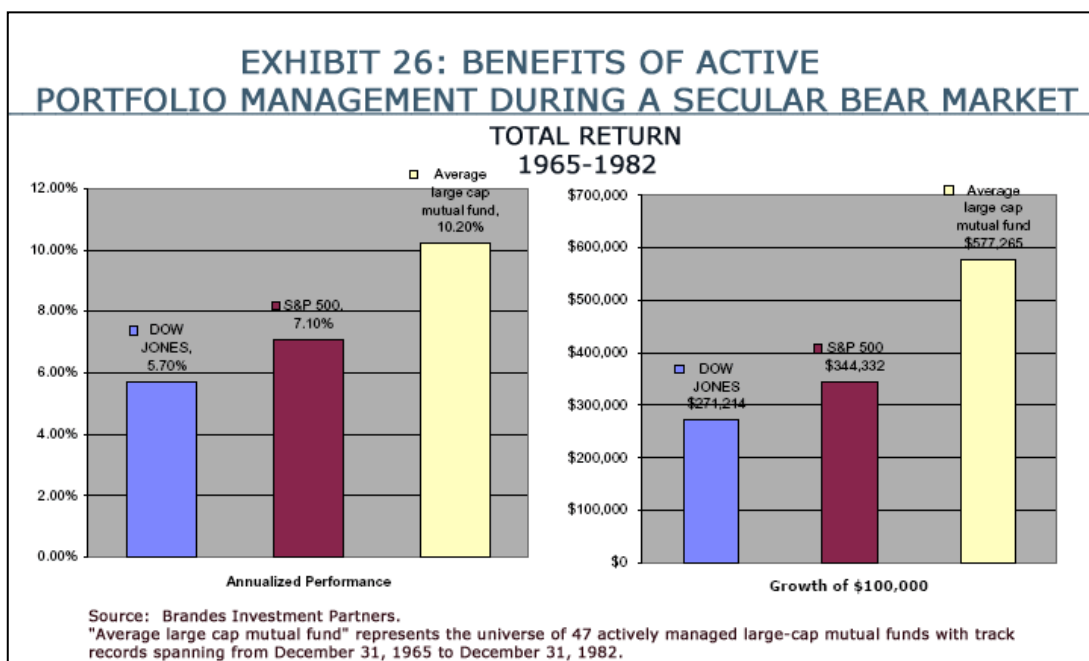
If you're like many investors, you'd assume that achieving success during a 16-year bear market is simply out of the question. The good news is that it's not impossible. Shorter market trends—known as *cyclical markets*—

Consider our secular bear market example. Exhibit 25 reveals that during that time there were no fewer than five *cyclical bull markets*—periods of strong gains from stocks. What's more, these cyclical bull markets often remained in effect for anywhere from six months to three years. Clearly,



investors did indeed have the opportunity to earn attractive returns during a 16-year period when the Dow remained essentially flat.

In fact, as Exhibit 26 shows, active mutual fund managers did indeed add substantial value to their investors above market returns during the



1965-82 bear market. The average actively managed fund gained 477 percent during the period—an annualized return of 10.2 percent. Investors who took an active approach to portfolio management during this time would have bucked the market's negative trend and come out with hundreds of thousands more dollars than investor who simply tracked either the Dow or the S&P 500. The key to this kind of success, however, is to use the right strategies at the appropriate times. To successfully navigate the ever-changing market environment, you must adapt your investment approach to take advantage of the specific forces at work during secular bull and bear markets.

Let's look first at what works during

secular bull markets. In a secular bull market, the rising tide of stock prices lifts all boats. Success comes mainly by being invested in the broad market through index funds or exchange-traded funds, for instance, that "own the market." These investments typically outperform managers trying to add value through superior stock selection and other forms of fundamental research.

You'll be best served by using the strategic method of investing, taking a buy-and-hold approach and keeping turnover low—essentially getting on the horse, grabbing the reins and riding as hard as you can. Exhibit 27 provides an overview of this approach.

And what does it take to succeed when the market is gripped by a long-term, secular bear market? As you can see

## **EXHIBIT 27: STRATEGIES DURING SECULAR BEAR MARKETS**

### **Secular Bull Markets**

(1922-1929, 1942-1965, 1982- March 2000)

#### **1. Portfolio Management Strategy: Passive or Indexing**

- Less value added from fundamental research, individual security selection and active portfolio management
- Passive indexes outperform the majority of active managers
- Portfolios broadly diversified
- Low tracking error, low portfolio turnover, low cost

#### **2. Asset Allocation Approach: Passive/Strategic**

- Buy and hold
- Limited rebalancing

Source: Ronald Cordes, Brian O'Toole and Richard Steiny, *The Art of Investing and Portfolio Management*, 2004.

in Exhibit 28, a secular bear calls for a fundamentally different approach. When the broad market is in a deep slump, there's no rising tide to lift all boats. Success requires superior active research and management efforts to uncover those investments capable of swimming against the tide and delivering strong returns.

It's clear that secular bear markets make it more difficult for investors to meet the rate of return objectives they need to reach their financial goals.

This means that, for many investors, it may be time for a new approach. You would be well served by reexamining your secular bull market strategies of the 1980s and 1990s in order to better respond to today's changing landscape in the financial markets.

In particular, your overall strategy should incorporate active portfolio management, a more concentrated portfolio and a tactical asset allocation approach.

## **EXHIBIT 28: STRATEGIES DURING SECULAR BULL MARKETS**

### **Secular Bull Markets**

(1922-1929, 1942-1965, 1982-March 2000)

#### **1. Portfolio Management Strategy: Active**

- Greater value added from fundamental research, individual security selection and active portfolio management
- An increasing number of active managers outperform indexes
- More concentrated portfolios
- Higher tracking error, higher portfolio turnover, higher cost

#### **2. Asset Allocation Approach: Active/Tactical**

- More opportunistic or active approach to asset allocation decisions
- More frequent reallocating and rebalancing

Source: Ronald Cordes, Brian O'Toole and Richard Steiny, *The Art of Investing and Portfolio Management*, 2004.

## Summary

Deciding how to invest your money can be one of the most important decisions that you can make for your future. The process of making this decision can be mired in uncertainty that is the result of conflicting emotions and information. As we have illustrated in the preceding text, both of these factors can negatively influence the performance of your investments.

Our recommendation- make sure that you create an investment plan, be sure to incorporate these three key concepts to investing success:

1. Bring great capability and knowledge to all your investment management decisions.
2. Follow a disciplined investment process.
3. Adapt to changing stock market environments.

By integrating these concepts into your investment plan, you will be that much closer to achieving success in investing, and securing the financial future that you envisioned for you and your loved ones.

We wish you success in attaining your financial dreams.

## About the Advisors



Upon graduating from West Chester University, where he earned a degree in Economics with a concentration in Finance, Mr. Carota began his initiation into the world of wealth management at American Express Financial Advisors, in Wilmington, DE. During his time at American Express, Mr. Carota helped to establish the West Chester, PA branch office. He was recognized by garnering such prestigious accolades as the Advisor Client Service Mercury Award for outstanding client service and achievement in managing and training support staff.

Having recognized his client's desire for independent unbiased advice, Mr. Carota launched The Carota Wealth Management Group in November 1997. Aspiring to work in a team environment and leverage the knowledge and experience of others, Mr. Carota merged Carota Wealth Management Group with Ambrose Financial Group in September 2001. In 2003, Mr. Carota established Brandywine Financial Group, Inc., A Registered Investment Advisor with the goal of providing Solutions to help build the Foundation for his clients financial Independence.

Mr. Carota's certifications include: insurance license in Life, Health and Annuities, as well as the following investment licenses; NASD Series 24 (General Securities Principal), NASD Series 7 (General Securities Representative), Series 63 (Uniform Securities Agent, State Law Exam), and Series 66 (Uniform Combined State Law Exam / Includes NASD Series 65: Uniform Investment Advisor Exam). Mr. Carota is always looking for ways to enhance his ability to serve his clients and is currently enrolled at the American College, Bryn Mawr, PA in pursuit of the Certified Financial Planner (CFP) designation.

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